Supreme Court, U.S.
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No. 03-529

IN THE

Supreme Court of the United States

AMERICAN ELECTRIC POWER COMPANY, INC., *et al.*,

Petitioners,

v.

UNITED STATES OF AMERICA,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

REPLY BRIEF

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RULE 29.6 STATEMENT

Petitioner, American Electric Power Company, Inc.'s corporate disclosure statement was set forth at page *iii* of its Petition for a Writ of Certiorari, and there are no amendments to that statement.

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1. The Brief for the United States in Opposition ("Brief") is not responsive to the Petition of American Electric Power ("AEP") ("Petition"). The Petition states in detail why it is appropriate for this Court to take a fresh look at the important tax questions presented, even though the Court denied the taxpayer's petition for review in *Winn-Dixie Stores, Inc. v. Commissioner*, 254 F.3d 1313 (11th Cir. 2001), *cert. denied*, 535 U.S. 986 (2002). Petition at 9-11. For example, the Petition points out that the trial court in this case – in contrast to the trial court in *Winn-Dixie* – acknowledged that AEP had a legitimate business purpose for its COLI investment. Petition at 3; Petition App. B. at 80a. The Petition also explains (at 2-3) that AEP, in contradistinction to the taxpayer in *Winn-Dixie*, established a trust for the benefit of rank and file employees and retired employees and dedicated the earnings from the COLI policies to that trust to pay for post-retirement medical benefits. In addition, AEP has shown – in contrast to the taxpayer in *Winn-Dixie* – that the actual insurance experience and financial results of its COLI program varied substantially from the results depicted in the original sales illustrations and, thus, its COLI program was not "locked" from the outset. Further, AEP has made the critical demonstration that the underlying insurance policies did indeed transfer insurance risk to the insurance company.

Moreover, the taxpayer in *Winn-Dixie* did not present evidence at trial relating to "third party" tax effects that, under this Court's precedent, have a bearing on the economic substance issue. *See Frank Lyon Co. v. United States*, 435 U.S. 561, 580 (1978). While the Internal Revenue Service ("IRS") fixates on the tax effect of AEP's deduction for policy loan interest, that tax effect is offset dollar-for-dollar by the tax effect of the carrier's inclusion of that same policy loan interest in its taxable income. Considering all parties to the transaction, the tax benefit of the transaction (and the source of the tax loss to the Treasury) derives solely from the fact

that while interest credited to AEP's insurance policy cash values (*i.e.*, inside buildup) is excluded permanently from AEP's taxable income, the carrier is entitled to a deduction for such interest. The tax benefit of inside buildup for life insurance is explicitly provided for by controlling statutes and is recognized as a tax subsidy in the federal budget. Petition at 11.

The Brief offers no response to these points, other than the empty gesture of appending a copy of the government's brief filed with this Court in *Winn-Dixie*, a filing with which AEP was already very familiar, as is evidenced by the Petition.

2. The Petition presents the question whether the federal courts should give the IRS the latitude to "trump" controlling statutes and disregard a bona fide life insurance program (or any other tax preferred investment) simply because the underlying transaction is not expected to produce a profit if the tax benefits of the transaction are disregarded. Petition at i. The government's version of the question presented simply assumes the answer to the issue in dispute (*i.e.*, whether the underlying facts constitute an economic sham) and, thus, elides the important question presented by AEP for consideration by this Court. Consistent with this evasive tactic, while the Brief asserts that the COLI plan at issue should be treated as a sham because illustrations that AEP received prior to purchasing the COLI policies projected a pre-tax loss of $268 million, it simply fails to cite any non-COLI authorities that support this far-reaching position. The Petition, in contrast, points to insurance and non-insurance tax cases where the government relied unsuccessfully on the presence of pre-tax losses in seeking expansion of *Knetsch v. United States*, 364 U.S. 361 (1960), and the economic sham doctrine. *See, e.g., United States v. Consumer Life Ins. Co.*, 430 U.S. 725 (1977); *Sacks v. Commissioner*, 69 F.3d 982 (9th Cir. 1995).

3. The fundamental problem with the pre-tax loss approach advanced by the government is that it permits the IRS to second guess the tax policy adopted by Congress in enacting laws that admittedly subsidize with tax benefits certain transactions that are unattractive investments absent their attendant (and intended) tax benefits. The COLI tax dispute here is a prime example of the IRS's second guessing.

Absent tax benefits, cash value life insurance is not an attractive investment.[1] There is, however, a longstanding tax policy that favors life insurance and permits corporations to participate in its tax benefits. That longstanding tax policy explicitly allows the benefits of broad-based COLI programs like AEP's during the 1996 tax year in suit. In 1996, Congress revised the tax law governing COLI by adding to then-current law, which imposed a $50,000 per insured employee limit on COLI policy loans for which interest was deductible, two additional rules for the 1996-1998 tax years. One new rule imposed a limit of 20,000 polices with respect to which loan interest deductions were permitted in broad based COLI plans. The other new rule put a cap on the loan interest rate that can be used in 1996 and later years to compute the allowable policy loan interest deduction. AEP complied with these new rules by repaying the loans on the policies over the 20,000 limit and by capping the rate used to compute the deductible portion of its COLI policy loan interest.

Here, the IRS wants to treat a broad-based life insurance program as a sham because it produces a loss, absent tax benefits. Since it is natural for *all* such plans to result in a loss absent tax effects, the practical effect of the government's position is to "sham" across the board all such programs and eviscerate the tax laws that unquestionably authorize the interest deductions for such programs.

1. A pre-tax loss is natural in COLI plans (Petition at 21-22) and non-COLI life insurance plans. *See, e.g., Shirar v. Commissioner*, 916 F.2d 1414 (9th Cir. 1990).

4. The government's contra-statutory perspective is well illustrated by its discussion of the insurance company's practice of offering a choice of interest rates (which admittedly affect both the crediting rate on inside buildup and the policy loan interest paid by the taxpayer). Brief at 3. The government's approach is to treat broad-based, leveraged COLI transactions as a sham because high interest rates have been used, when the approach dictated by Congress is to allow an interest deduction, subject to a statutory cap. Health Insurance Portability and Accountability Act of 1996, Pub. L. No. 104-191, 110 Stat. 1936, 2090-93 (Aug. 21, 1996). The result the government seeks is to permit no loan interest deduction whatsoever; the approach mandated by Congress is a reduced deduction subject to a cap. The Brief omits any discussion of the controlling statutes that addressed Congress's concerns relating to increased interest rates and the resolution of those concerns with a statutory cap rather than wholesale denial of the interest deduction.

5. Despite the government's dismissive footnote (Brief at 8-9), subsequent to this Court's decision in *Knetsch* (involving loans under annuity policies), a circuit conflict developed (and continues) over how, if at all, the decision in *Knetsch* applies to life insurance policies financed with substantial amounts of policy loans. The Tenth Circuit in *Goldman v. United States*, 403 F.2d 776 (10th Cir. 1968), and *Golsen v. Commissioner*, 54 T.C. 742 (1970), *aff'd*, 445 F.2d 985 (10th Cir.), *cert. denied*, 404 U.S. 940 (1971), applied *Knetsch* to these complex policy loan-driven transactions and disallowed deductions for loan interest expenses. On identical facts, the Fifth and Sixth Circuits ruled in favor of the taxpayers, reasoning that the non-policy loan aspects of the policies provided life insurance benefits that had substance. *Campbell v. Cen-Tex, Inc.*, 377 F.2d 688 (5th Cir. 1967); *Woodson-Tenent Labs., Inc. v. United States*, 454 F.2d 637 (6th Cir. 1972). Petitioner cited the government's

brief in *Golsen*, which was submitted to this Court over thirty years ago, because that brief correctly described the earlier precedent as presenting a circuit conflict over the application of *Knetsch* to life insurance programs, and because the *Golsen* brief contradicted the government's "spin" in the current COLI controversies as set forth in its *Winn-Dixie* brief. In *Winn-Dixie*, the government implied that the post-*Knetsch* precedent consists of a seamless string of cases that all favor the government's application of *Knetsch*. In fact, as the *Golsen* brief filed with this Court over thirty years ago makes clear, the federal courts have struggled with the application of *Knetsch* in the life insurance context for a long time, with uneven results. Moreover, by declaring in its *Golsen* brief that the policy loan interest conflict was rendered moot in light of enactment of the safe harbor rule of section 264, the government, in *Golsen*, appeared to adopt the concept (with which AEP agrees) that statutes targeted at particular transactions and specifying particular tax outcomes should take precedence over the application of common law doctrines, such as the economic sham doctrine, that are generally applicable in filling statutory vacuums. Obviously, the government has abandoned its earlier approach but, contrary to the comments made by the government (Brief at 8 n.2), it was not "frivolous" for AEP to point to the government's prior position and to its change in position.

6. Seeking to avoid the force of the older cases, the Brief relies (Brief at 8 n.2) on the fact that those cases involved small life insurance programs, not broad-based plans involving thousands of policies. The suggestion that large COLI plans lack substance due to their size collides with the controlling statutes that provide (among other things) that for the tax year in issue, 1996, a taxpayer may deduct loan interest on up to 20,000 COLI policies. More specifically, the government seeks to establish a lack of economic substance based on the fact that AEP's COLI plan was

experience rated, *i.e.*, because the insurance company followed a very common insurance practice of setting insurance charges at levels that would likely be sufficient to pay anticipated claims, refunding excess charges when they were more than sufficient, and charging an actuarial fee to cover the risk that claims exceeded the expected amount. It is settled law that experience rating has substance for tax purposes where (as here) there is both insurance risk transfer and a valid business purpose. *See, e.g., United States v. Consumer Life Ins. Co.*, 430 U.S. 725 (1977); *Sears, Roebuck & Co. v. Commissioner*, 972 F.2d 858 (7th Cir. 1992), *amended*, 1992 U.S. App. LEXIS 25976 (7th Cir. Oct. 14, 1992).

7. On October 15, 2003 – two weeks after the Petition was filed by AEP – the Solicitor General underscored the importance of the legal issues at stake in the contested COLI cases by authorizing the appeal by the government of a decision adverse to it in another broad-based COLI case. *Dow Chem. Co. v. United States*, 250 F. Supp. 2d 748 (2003), *modified*, 278 F. Supp. 2d 844 (E.D. Mich. 2003), *appeal docketed*, No. 03-2360 (6th Cir. Oct. 27, 2003).

The current broad-based COLI cases (*Winn-Dixie*, 254 F.3d 1313; *IRS v. C.M. Holdings, Inc.*, 254 B.R. 578, 601 (D. Del. 2000), *aff'd*, 301 F.3d 96 (3d Cir. 2002); *Am. Elec. Power Co. v. United States*, 136 F. Supp. 2d 762 (S.D. Ohio 2001), *aff'd*, 326 F.3d 737 (6th Cir. 2003); *Dow Chemical*, 250 F. Supp. 2d 748) all involve post-1986 programs. However, in a recent filing in the Sixth Circuit in *Dow*, the government indicated its intention to extend application of its "pre-tax loss" argument to leveraged life insurance programs put in place before the $50,000 loan cap was enacted in 1986. United States' Motion for Reconsideration of Order Denying its Motion For Expansion of Word Limit, *Dow Chemical v. United States*, No. 03-2360, at 2-3 (Nov.

20, 2003) ("Government's Motion in *Dow*"). According to the government, the planned extension to pre-1986 COLI plans of the pre-tax loss position developed in the recent COLI cases could generate tax disputes involving up to $4 billion. Government's Motion in *Dow* at 3. The government's filing in *Dow* also emphasizes the government's belief that post-1986 cases, such as *Dow*, continue to be of "critical importance" in that their resolution will have a "major impact on the federal fisc." Government's Motion in *Dow* at 2.

8. Finally, there are no alternative holdings in the trial court below that would support a decision in favor of the government on the merits. The Brief (at 6) refers to two "sham in fact" findings of the trial court. One such finding, *i.e.*, that premiums paid for with dividends are factual shams, was rejected by the Sixth Circuit in this case, and rejected by the Third Circuit in *C.M. Holdings*. 301 F.3d 96. The second trial court finding cited by the government, *i.e.*, that policy loans made effective prior to the delivery of the COLI policies to AEP in 1990 were shams-in-fact for the months preceding delivery of the policies, was not challenged on appeal by AEP since there is no dispute that the loans were real during the tax year in suit (1996).

CONCLUSION

For the reasons stated above and in the Petition, the Petition should be granted.

Respectfully submitted,

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